INVESTMENT ADVISORY GROUP

2020 OUTLOOK

THE DANCE CONTINUES

TWO STEPS FORWARD, ONE STEP BACK

GENSPRING℠
SUNTRUST PRIVATE WEALTH

The Dance Continues: Two Steps Forward, One Step Back

Contents

In 2020, we see a slightly better global economic growth environment but modest capital market returns relative to the stellar gains of 2019.

We expect the global economy and markets to take two steps forward as stimulus measures lead to firming global growth, but policy uncertainty will cause markets to periodically take a step back. Easing US-China tensions are likely to be interrupted by periodic flare ups. The US election will come into focus, and markets will ebb and flow with the changing dynamics of the race. Equities should outperform fixed income, but investors will need to decipher how much of the improved earnings backdrop and fading headwinds, such as receding recession risks, are already discounted into stock prices. The push and pull interest rate environment is set to continue.

The Dance Continues: Two Steps Forward, One Step Back

2020 Key Themes

Economy: Modest Growth Uptick

Global growth should increase, driven by the lagged effect of aggressive monetary stimulus measures and easing geopolitical tensions.

We anticipate steady growth in the US of around 2.3% as the resilient consumer continues to carry the economy forward.

Growth in international developed markets is expected to stabilize, while activity in the emerging markets should see a slight pickup.

Equities: Glass Half Full

Following the strong gains seen in 2019, we anticipate more average-like stock returns in 2020.

Stocks should be well supported by a modest global recovery, accommodative monetary policy and improved earnings trends. However, this improved backdrop is already partially reflected in equity prices.

Stocks still remain attractive on a relative basis and should be among the better performing asset classes.

Fixed Income: Push and Pull

We expect fixed income returns in 2020 to be more muted after the stellar returns of 2019.

US rates should gyrate given the push of firming global growth and easing geopolitical tensions against the pull of low inflation, aging demographics and the strong demand for yield and safe-haven assets.

We anticipate opportunities to lengthen portfolio duration closer to neutral as rates rise.

OUTLOOK 2020

2020 Asset Class Views and Forecasts

- **Equity tilt relative to fixed income**

- **Maintain US equity bias:**
  - Size: Large Cap bias
  - Style: Neutral growth/value
  - Favored Sectors: Financials and Industrials

- **International Developed Markets:**
  Less attractive but relative opportunity in small caps

- **Emerging Markets:**
  Neutral; active management is key

- **Bonds:**
  Maintain high quality bias along with modest high yield position
  - Look for tactical opportunities to increase duration and credit
  - Avoid International Developed Markets Bonds
  - Favor EM hard currency over EM local currency bonds

- **Non-Traditional Strategies:**
  Generally, favor less directional managers

Asset Classes	Less Attractive			More Attractive	
Equity				●	
Fixed Income		●			
Commodities	●				
Cash			●		

Global Equity	Less Attractive			More Attractive	
US Large Cap					●
US Mid Cap			●		
US Small Cap			●		
International Developed Markets		●			
Int'l Developed Markets Small Caps				●	
Emerging Markets (EM)			●		
Growth & Value Style			●		

US Fixed Income	Less Attractive			More Attractive	
US Government	●				
US Mortgage-Backed Securities				●	
US Investment Grade Corporate (IG)			●		
US High Yield Corporates (HY)				●	
Floating-Rate Bank Loans		●			
Duration		●			

Key 2020 Forecasts

2020 Global GDP Forecast**	3.1%
IAG Forecast US GDP Range	2.2% - 2.4%
IAG Forecast Fed Funds Rate Range	1.50% - 1.75%
IAG Forecast 10-Year US Treasury Yield	1.50% - 2.50%
IAG S&P 500 P/E Ratio Range	16x - 19x
S&P 500 12-Month Forward EPS***	$177.68

**Bloomberg Consensus; ***FactSet Estimates

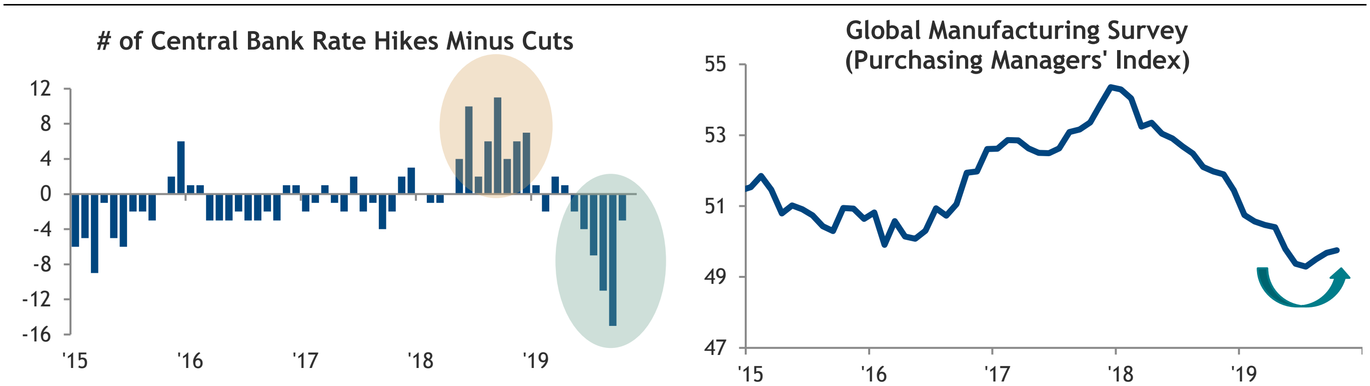
Modest Growth Uptick

We anticipate a modest uptick in global economic growth in 2020, driven by the lagged effect of aggressive monetary stimulus measures and easing geopolitical tensions. US growth should have another solid year, international developed markets are expected to stabilize, and activity in the emerging markets should see a slight pickup.

After several years of moderating trends, global growth is set to see a slight improvement in 2020 thanks to improved financial conditions. Although we see a firming recovery, the International Monetary Fund's (IMF) call for a rise in global growth from 3.0% in 2019 to 3.4% in 2020 appears overly optimistic; it is more likely that growth comes in closer to the consensus forecasts from private economists of 3.1%. We expect US growth of around 2.3%, which is above consensus forecasts.

The lagged impact of tighter central bank policies in 2018 along with trade uncertainty contributed to the global economic slowdown witnessed over the past year. However, central banks have sharply reversed course, aggressively lowering interest rates over the past six months. The Federal Reserve (Fed) cut interest rates three times in 2019 and appears to have successfully navigated an intra-cycle economic slowdown, which should extend the record-long US expansion. Likewise, the European Central Bank (ECB) relaunched quantitative easing, and central banks across the emerging markets (EM) have also ramped up monetary support. The stimulative effect of these actions should be visible in the upcoming year with investment demand and business confidence slowly rising, leading to an improvement in global manufacturing (Figure 1).

Figure 1: Aggressive Central Bank Rate Cuts to Support Global Growth



Data Source: SunTrust IAG, Haver
Left chart: Series constructed using most countries in the MSCI All Country World Index. A positive number represents net hiking while a negative number represents net cutting.

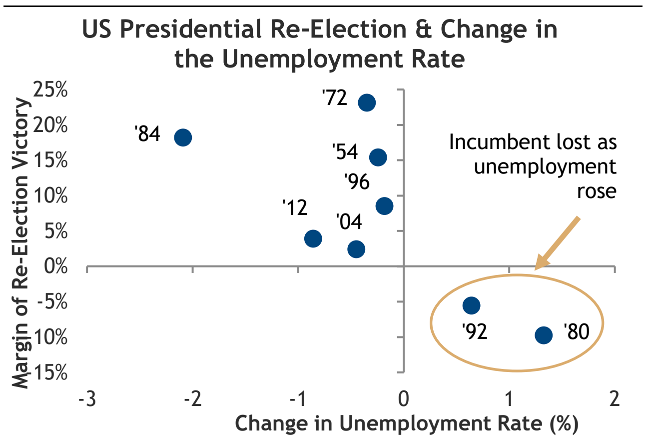
GLOBAL ECONOMY

A US-China trade truce should be an important catalyst for global economic activity. Increasing tariffs and uncertainty weakened trade and remained an overhang for the global economy during the past year. Although periodic flare ups are to be expected, there is an incentive for the White House to avoid having trade remain an overhang for the economy during an election year. The last two US presidents who were not re-elected, Jimmy Carter and George H.W. Bush, had a rising unemployment rate in common (Figure 2).

The global economy should be supported by a slightly better manufacturing backdrop along with a stable services sector in 2020. The services sector, which is larger than manufacturing, continues to be in expansion mode across the globe. A solid services sector is providing steady employment creation and buttressing consumer confidence and domestic demand.

We stress that we are only looking for a slight uptick to global growth in 2020 rather than the more robust recovery that occurred after the 2016 global sluggishness. Chinese stimulus, a key factor in boosting global growth following past downturns, is more modest and targeted in this cycle as the country continues to reduce leverage. China's economic growth rate is expected to stay on its current trajectory, falling below 6% for the first time since 1990, but this is widely expected and still an enviable growth rate for a $15 trillion economy.

Figure 2: Election Provides Incentive for US-China Truce



Source: Strategas, SunTrust IAG

Europe's growth is set to stabilize at low levels. Europe was hit hard with external demand weakening and new emission standards on cars affecting manufacturing output. We anticipate this will be less of a drag in 2020. Similarly, the Brexit deadline was pushed back three times with uncertainty still lingering after each postponement. A resolution in the coming months, however, should provide a boost to business sentiment.

The Japanese economy is expected to remain flat over the next year. The October consumption tax increase pulled forward a small portion of 2020's demand into 2019. However, the Japanese government has launched a large fiscal stimulus plan, equivalent to 1.9% of GDP, to support growth.

Beyond China, the economies of the emerging markets (EM) should add to growth in 2020 but less so than the IMF's forecast. The reduction in global interest rates and lower borrowing costs are helping to stimulate these economies, while lessening trade tensions would also be helpful. Moreover, South Korea is ramping up its fiscal stimulus, Brazil passed important pension reforms, and Turkey is recovering from a recession. Russia and Mexico are also expected to grow faster next year. India's economy will continue to deal with banking issues and credit availability, suggesting growth will remain much lower than its potential of 7%. Political upheaval will also weigh on some of the smaller Latin American countries.

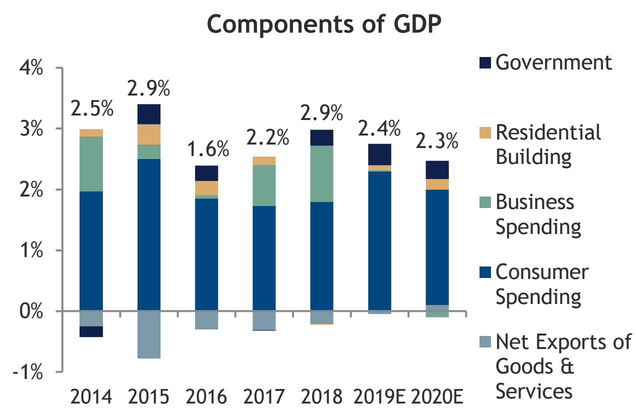
US: Slow but Steady

We anticipate that 2020 real gross domestic product (GDP) growth will be around 2.3%. While not a robust pace, it is in line with the average growth achieved over the course of the past decade. The resilient consumer, accounting for roughly 70% of US GDP, should continue to carry the economy (Figure 3).

Retail sales are rising at a healthy clip of 3.4% in 2019. Auto sales are also chugging along at a pace of just under 17 million units, which has roughly held for an unprecedented five-year span. Meanwhile, the labor market continues to be strong. Workers are seeing solid wage gains while the unemployment rate and weekly jobless claims both sit near 50-year lows.

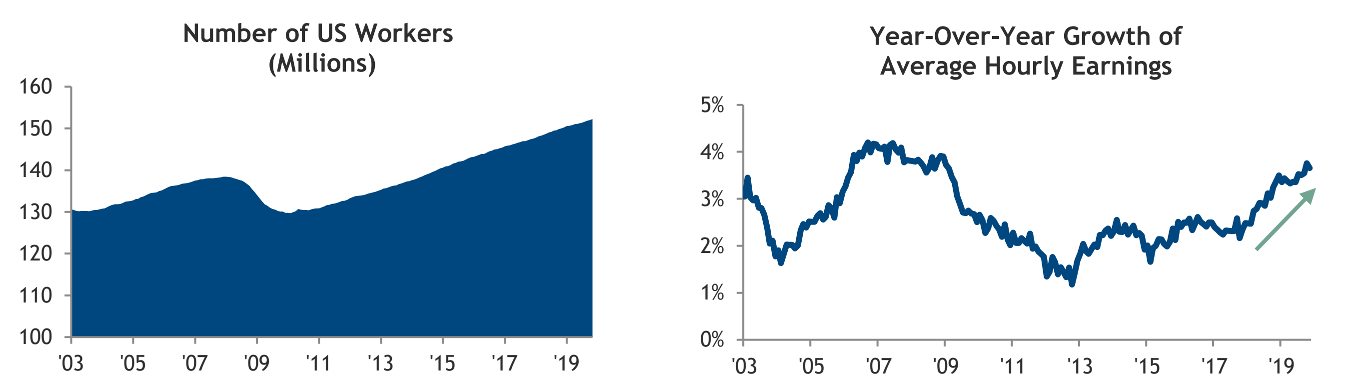
In 2020, we expect an average of roughly 125,000 to 155,000 new jobs per month. This slower pace relative to recent years is to be expected as we move later into the business cycle and given the already low unemployment rate. Ultimately, more workers with steady hours and higher wages translate into bigger paychecks, which should equate to continued consumer spending (Figure 4).

Figure 3: Consumer Should Continue to Drive US Economy



Data Source: SunTrust IAG, Bureau of Economic Analysis; SunTrust IAG forecasts for 2019E/2020E.

Figure 4: Increasing Labor Force and Wages Supporting Consumer Spending

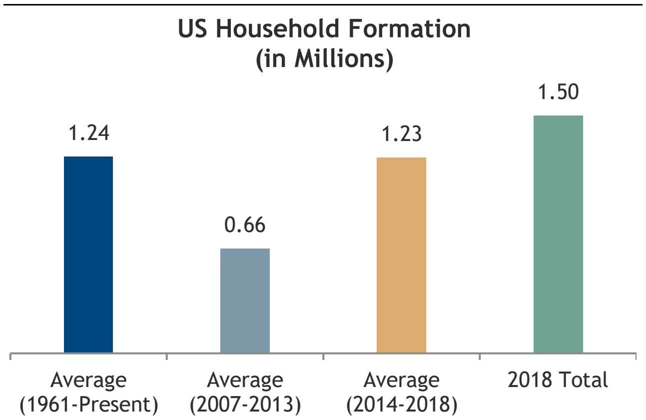


Data Source: SunTrust IAG, Bureau of Labor Statistics, Haver. Nonfarm payrolls (left chart), average hourly earnings for production and supervisory workers (right chart).

Furthermore, we expect housing to experience a mini resurgence driven by a shortage of homes, pent-up demand, demographics, and lower mortgage rates. Housing supply is tight due to underbuilding during the recovery, while housing demand is rising. Household formation, driven by the 75 million millennials who are coming of age and account for nearly a quarter of the total US population, has reaccelerated over the past five years (Figure 5). Although home prices have risen nationally over the past few years, home affordability is bolstered by low mortgages rates.

The business spending outlook is more mixed with trade uncertainties rippling through supply chains in addition to the upcoming US elections. There should also be milder headwinds than we saw during 2019. For instance, there should not be a repeat of the government shutdown, the tariff-related inventory buildup nor the Boeing 737 Max delivery backlog. The last two translate into a boost of net exports, which should flip to a modest positive for the first full year since 2013.

Figure 5: Millennials Driving Increased Housing Demand



Data Source: SunTrust IAG, Bloomberg, US Census Bureau
2018 most recent data available

Lastly, government spending will be buoyed by state and local outlays, which are roughly 60% of total government expenditures or 11% of the total US economy. State and local budgets should remain solid, driven by state sales taxes, personal income taxes, and property taxes. On the federal level, spending should be generally stable, boosted by the 2020 Census and a modestly higher defense budget.

Downside/Upside Risks

We see the global economy doing modestly better in 2020, but a further escalation of trade disputes poses a risk to global trade and our outlook. World trade volumes are already at recessionary levels, stressing global manufacturing supply chains. The upcoming US elections also add a degree of uncertainty. Conversely, a more substantial breakthrough in US-China relations could lead to a sharp pickup in consumer and business confidence. Likewise, if Germany, and other countries around the globe, heed the call to enact fiscal stimulus, this would go a long way toward boosting global growth.

Glass Half Full

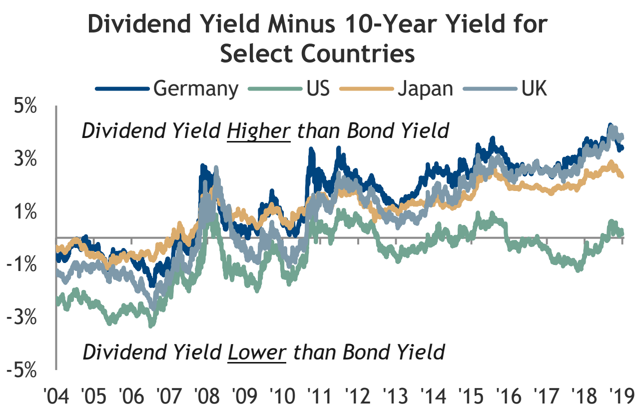
Following the strong gains seen in 2019, we anticipate more average-like stock returns in 2020. Equities should be well supported by a modest global recovery, accommodative monetary policy and improved earnings trends. However, this improved backdrop is also partially reflected in valuations, and the hurdle rate for positive surprises has risen. Stocks still remain attractive on a relative basis, and the path of least resistance remains higher.

A Look Back and Ahead

It has been a tale of two markets over the final two years of the decade. In 2018, global equity markets declined as central bank tightening coupled with geopolitical tensions led to rising recession concerns and a slowing earnings growth outlook. Subsequently, stock valuations and investor expectations became depressed. This low starting point set the stage for a powerful market rebound as global central banks aggressively cut rates and several headwinds faded.

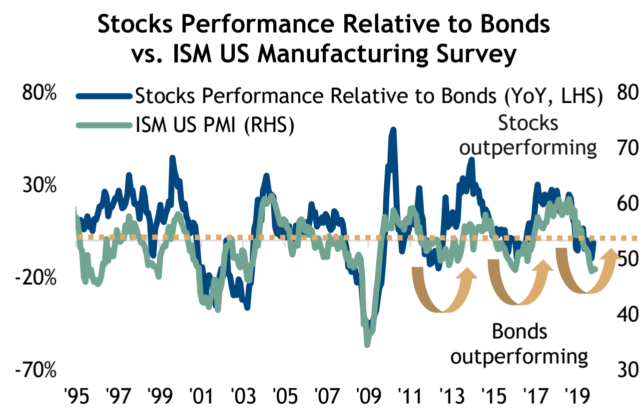
In 2020, we see a tug-of-war playing out between an improved macro backdrop and higher valuations. Market gains are likely to moderate, but we expect stocks to outperform most other asset classes. While absolute valuations are high, many stock market indices around the globe have dividend yields well above that of their respective benchmark government bond yields (Figure 6), and improved global economic trends should support earnings growth. Manufacturing surveys also appear to be bottoming—this has historically been consistent with equity outperformance relative to bonds (Figure 7).

Figure 6:
Global Stock Dividend Yields Above Government Bond Yields



Data Source: SunTrust IAG, FactSet
Germany: DAX and 10-Yr Govt Bond Yield; Japan: FTSE Japan and 10-Yr Govt Bond Yield; UK: FTSE 100 and 10-Yr Govt Bond Yield; US: S&P 500 and 10-Yr US Treasury Yield

Figure 7:
Bottoming in Manufacturing Should Aid Stock Outperformance



Data Source: SunTrust IAG, Morningstar, Haver
Stocks represented by the S&P 500 Index; Bonds represented by Bloomberg Barclays US Aggregate Bond Index
LHS = left-hand side; RHS = right-hand side

Positioning

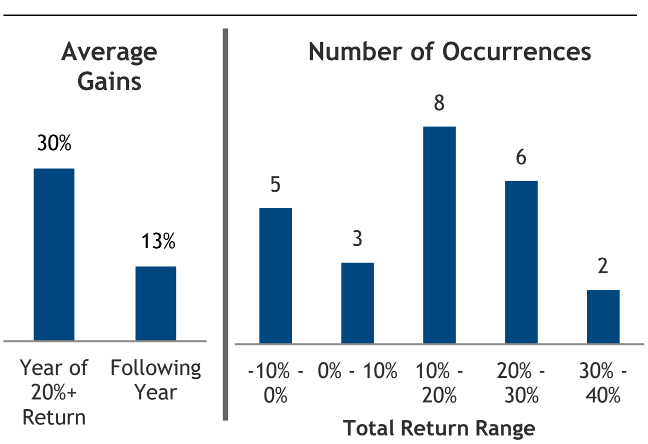
We maintain a US bias, but emerging and international developed markets should also benefit from firming global economic trends. We expect the US outperformance cycle to narrow. However, for international markets to significantly outperform, a more robust global economic recovery and a weaker US dollar than we expect would likely be required. Within international developed markets, we see a relative opportunity in small caps as global liquidity rises. From a sector perspective, we generally prefer cyclicals, such as financials and industrials.

Regional Outlook

United States: Maintain Favorable Bias

The bull market is poised to continue. US stocks are on track to finish 2019 with the best annual gains since 2013. Since World War II (WWII), there have been 24 years where the S&P 500 posted a total return of more than 20%; stocks rose the following year in 19 occurrences, or 79% of the time, with an average gain of 13% (Figure 8). Three of the five years where stocks failed to post gains occurred during periods that included recessions (1981 and 1990) or shortly before a recession (2000).

Figure 8: S&P 500 Total Returns in Years after 20%-Plus Gains



Data Source: SunTrust IAG, FactSet

While history is only a guide and other factors should also be considered, this study shows that big gains in one year are typically followed by gains, albeit more modest, the next year. It is also important to note that the 2019 gains came from depressed levels following the late 2018 selloff. The bigger picture is the S&P 500 had traded in a range for the better part of 21 months before breaking to the upside in the fourth quarter of 2019 (and is only 8% above the September 2018 peak).

The S&P 500's forward price-to-earnings (P/E) ratio has risen to the highest level since early 2018, indicating a fair amount of good news is baked into stock prices. Valuations, however, appear less problematic when taking into account the low interest rate and inflation backdrop.

The equity risk premium—which compares the earnings yield of stocks to bond yields—is at a level that has been associated with average one-year forward returns of 12%. Also, about 50% of stocks in the S&P 500 have dividend yields greater than the 10-year US Treasury yield; this statistic is well above the 30-year average of 18%.

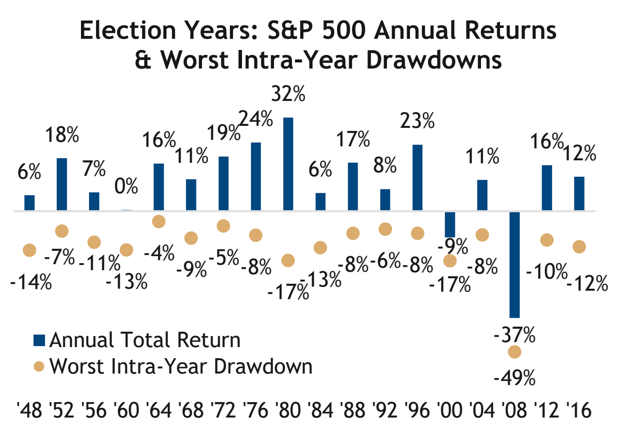
Even though we still see relative value in stocks, the carousel of concerns will continue to turn. US politics is a primary source of uncertainty in 2020.

Election Year Considerations

Stocks have tended to rise during election years but also usually see at least one correction. The S&P 500 has climbed in 16 of 18 election years since WWII, with an average total return of 10% (Figure 9). The two times the market declined—2000 and 2008—were during a recession or leading up to one. This is consistent with most of our work that suggests politics are a factor when investing, but the economy and fundamentals are typically the stronger drivers.

At this point, market-based gauges still indicate a high probability of a continued divided government, which would make it more difficult to enact sweeping changes that could rattle markets. The deepest intra-year pullbacks during past election years have averaged 12%. This suggests that markets are likely to see a temporary pullback during the year that is deeper than the worst setback of just 7% seen in 2019 (as of mid-December).

Figure 9: Stocks Tend to Rise During Election Years but Also Usually Have an Intra-Year Correction



Data Source: SunTrust IAG, Morningstar

Market Upside/Downside Scenarios

Forecasting where a market will stand on an arbitrary day, such as December 31, or any other random day, is treacherous at best, especially considering valuations historically have had little correlation with near-term returns. Therefore, we place a much greater emphasis on, and have greater confidence in, market direction and relative opportunities.

For tactical decision making, we find it insightful to consider factors which could lead to markets moving toward the top or bottom of a given range. Since 1950, the average gap between the S&P 500's closing high and low price in any year is 27%.

As a starting point, we view a reasonable 2020 baseline price return assumption for the S&P 500 in the mid- to high-single digits. This assumes valuations stay near the forward price-to-earnings ratio of 18 times, and returns are driven primarily by profits. Incorporating our macro outlook, we estimate S&P 500 earnings of $176 for 2020 and $185 for 2021, which equates to about 6% annualized profit growth. Notably, earnings tend to rise outside of recessions, and stocks have increased 85% of the time on a one-year rolling basis during expansionary periods.

In a more bullish scenario, the S&P 500 could lift toward 3550, which implies a forward P/E of 19x applied to a slightly improved earnings outlook. This represents 12% price upside to the mid-December market level of 3169. This return would align more with gains after big up years and the current level of the equity risk premium.

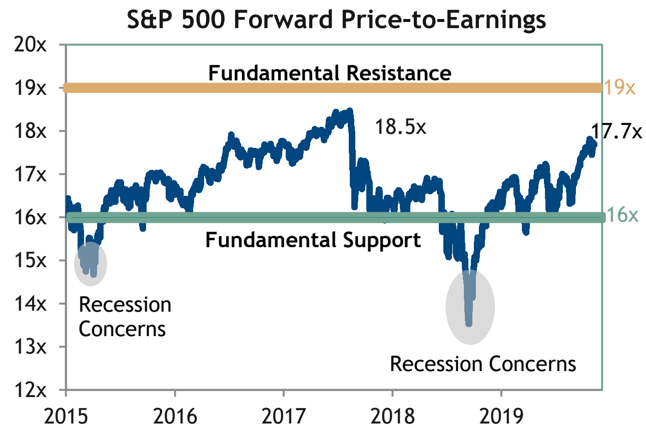
This upside scenario would likely require a stronger-than-expected global recovery and/or a more substantial US-China trade deal. Another positive market catalyst could be a return to positive equity fund flows—outflows jumped to the highest level in more than 20 years during 2019. Hedge funds also have room to increase equity exposure from current low levels.

This outcome suggests that valuations move slightly above the 18.5x P/E cycle peak reached in early 2018, shortly after the US tax reform package was passed. This is a high valuation threshold, but the 10-year US Treasury yield is roughly one percentage point lower today, and the Fed has been reducing short-term rates as opposed to raising them back then.

In a more negative scenario, we could see the market fall to about 2750. This implies that the S&P 500's P/E ratio compresses to 16x as well as a more depressed earnings outlook. This represents about 13% downside from current levels.

This outcome would likely be caused by an escalation in trade tensions, a lack of traction in the global economic recovery or an unexpected spike higher in interest rates. Notably, in the second half of 2019, including during periods of heightened tariff rhetoric, buyers stepped in to support the market several times near a 16x P/E ratio (and it also traded above that for most of 2018). Moreover, the Fed has cut rates three times since July, which is supportive of valuations. The 2750 area also aligns with technical price support. A drop below this level would suggest rising recession concerns (Figure 10).

Figure 10: S&P 500: Valuation Resistance & Support Levels



Data Source: SunTrust IAG, FactSet

Positioning Within the US

Emphasize Large Caps, for Now

We continue to have a US large cap bias given their stronger earnings trends and a high quality bias. After an extended period of underperformance, small and mid cap valuations have become attractive relative to large caps; however, earnings for these companies have been weakening for more than a year on a comparative basis. In addition, roughly a third of small cap companies are not profitable, margins are getting squeezed and rising wages pose a further threat. Similarly, mid cap earnings revision trends have been steadily eroding.

Trade uncertainty also appears to have weighed on business confidence, which has gone hand-in-hand with small cap performance. Thus, rising confidence as well as an upturn in relative profit and price trends are among factors we are monitoring to shift our view.

Value/Growth: Starting the Year Neutral

The growth style has benefitted from investors' willingness to pay a premium for companies that have been able to produce strong sales and profits during a tepid economic backdrop. However, firming global growth and interest rates are good news for value, including financials, the style's largest sector.

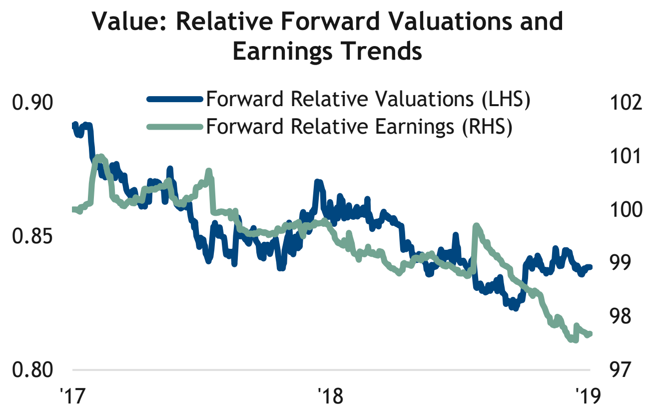
Thus, we advise investors that have had a large growth overweight to consider paring back toward a neutral weighting. We are watching for further confirmation that the uptick in the macro backdrop is translating into better earnings (Figure 11), as well as for cracks in technology leadership, by far the largest sector weight in growth, before tilting more toward the value style.

Favored Sectors: Financials & Industrials

We have a positive outlook on financials and industrials in 2020. The financial sector appears as one of the most attractively valued sectors in our work. Financials also fared better than many investors would have expected given the challenging interest rate environment over the past year, and the macro backdrop is now improving.

Similarly, the industrials sector stands to benefit as the global economy recovers from the third manufacturing slump of this expansion. Industrials, along with financials, led the rebound in the aftermath of the 2012 and 2016 slowdowns. Industrials would also be among the biggest beneficiaries of an improving trade outlook. Conversely, we have a less favorable outlook on defensive areas of the markets, such as utilities, which are trading at elevated valuations and are highly sensitive to interest rates.

Figure 11: Value Style: Relative Valuations Cheap, but Earnings Momentum Weak



Data Source: SunTrust IAG, FactSet
LHS = left-hand side; RHS = right-hand side

International Developed Markets: Underweight but Small Caps a Relative Opportunity

We are maintaining an underweight position but have seen enough signs of improvement in the data to warrant a slightly more positive view of international developed markets (IDM). For these markets to outperform in a signifcant and sustainable way, however, it would likely require stronger economic growth trends and a weaker US dollar than we anticipate.

On the positive side, IDM remains cheap, and the hurdle rate for positive surprises is low. Moreover, global monetary policy pivoted to a dovish stance over the past year, and easing financial conditions should support these markets. On the other hand, IDM continues to face structural challenges, such as poor demographics, elevated geopolitical risks, weak fundamentals for European banks and tepid earnings trends. China's stimulus is also more domestically oriented rather than focused on investment spending, which has not been as supportive for global trade.

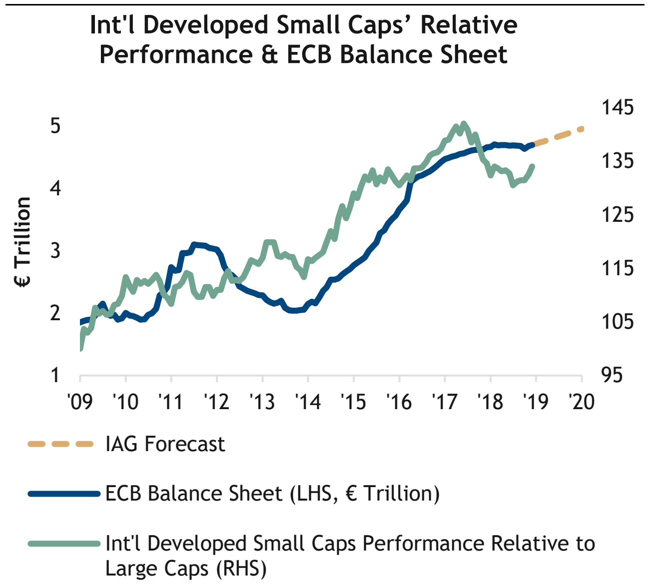
Within IDM, we see a relative opportunity in small caps. These companies should benefit from a trough in global growth and accommodative monetary policy. While the broad global equity market is back to new highs, IDM small caps are still down about 10% from the early 2018 peak. Consequently, relative valuations are more attractive, and relative earnings and price trends are improving. With global central bank balance sheets on the rise again, the liquidity environment has also become more supportive for IDM small caps' outperformance (Figure 12).

Emerging Markets: Neutral Outlook; Active Management Key

We expect emerging markets' (EM) performance to improve relative to global equities after lagging by a wide margin in 2019. The US-China trade conflict and slowing economic activity created strong headwinds for EM, which are leveraged to global growth. These factors should be less of an issue during 2020, while rising global liquidity, lower borrowing costs, and stabilizing currencies should be supportive for EM. Earnings trends are also showing tentative signs of stabilization.

We are held back from going overweight by fairly neutral valuations, our expectation for only a modest uptick in global growth and EM being the consensus fund manager overweight position. This suggests that investor expectations remain relatively high.

Figure 12: Int'l Small Caps Aided by Increasing Liquidity



Data Source: SunTrust IAG, Bloomberg
Relative performance indexed at 100 as of 12/31/2009

With China accounting for roughly a third of the emerging markets index and a notable variation in country performance, we see the role of active management as increasingly important in this asset class.

Push and Pull

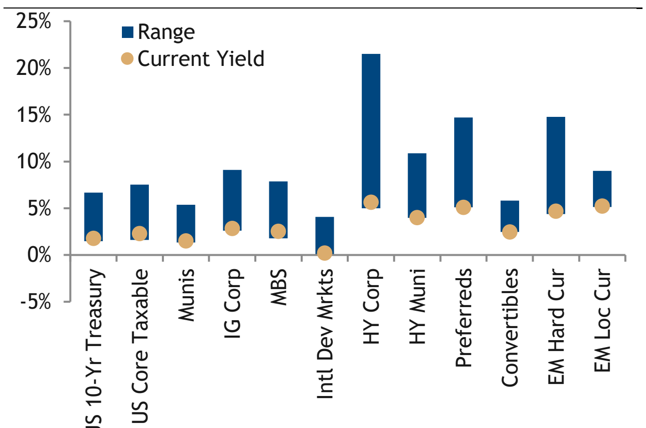
After the robust returns of 2019, our expectations for fixed income returns in 2020 are more muted. We expect US rates to gyrate given the push of firming global growth, easing geopolitical tensions, and less investor fear against the pull of low inflation, aging demographics and the strong demand for yield and safe-haven assets. We are primarily focused on high quality bonds to manage risk but also see value in a modest high yield position for the income pickup. Throughout the year, we anticipate opportunities to lengthen portfolio duration closer to neutral as rates rise.

Rate Expectations

Bond yields are depressed across the globe following monetary easing and the growth slowdown of 2019. Furthermore, interest rates in the US are being weighed down by the more than $11 trillion of negative yielding debt. As a result, valuations for most fixed income asset classes have become more expensive, and we expect this to translate into subdued returns ahead (Figure 13).

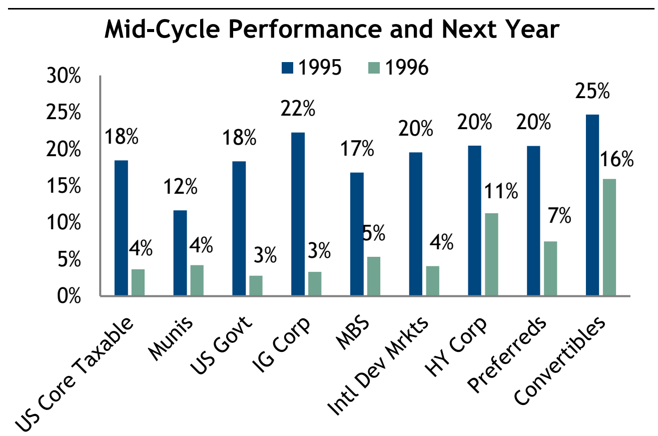
We believe 2020 may resemble the pattern that occurred after the Fed cut rates three times during the 1995-1996 mid-cycle adjustment (although rates and returns were much higher then). Similar to 2019, bond performance was very strong in 1995, aided by Fed rate cuts. However, in 1996, the Fed paused, and bond returns were significantly lower (Figure 14).

Figure 13: Bond Yields at Low End of 20-Year Range



Data Source: SunTrust IAG, FactSet

Figure 14: Lower Returns After '95-'96 Mid-Cycle Adjustment



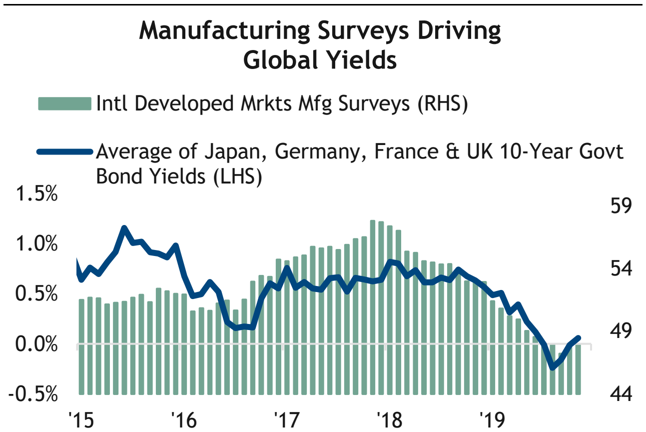
Data Source: SunTrust IAG, FactSet

GLOBAL FIXED INCOME

We expect monetary policy to remain accommodative for the foreseeable future given the structural headwinds to growth and inflation. The Fed is firmly on hold, and the bar for rate hikes in 2020 is high. Furthermore, the Fed is currently buying about $60 billion per month in short-term Treasury bills, which is set to continue through at least the first half of next year. This should help increase liquidity in the financial system and keep a lid on short-term rates. Other central banks, such as the ECB, are also providing monetary easing in terms of rate cuts and asset purchases.

Our macro outlook supports slightly higher yields (Figure 15); however, ongoing structural headwinds should limit the upside for rates in 2020. That said, a great deal hinges on easing geopolitical tensions. A more comprehensive US-China trade deal leading to better growth could send rates significantly higher. Conversely, escalating trade tensions could slow growth and pull rates toward their 2016 lows. While these scenarios present a risk to our outlook, neither of these outcomes are our base case.

Figure 15: Bond Yields Should Stabilize with Economy



Data Source: SunTrust IAG, FactSet, Haver

Positioning

Our positioning balances rates and spreads, which remain near all-time lows, against the strong demand for yield and safe-haven assets. We maintain a high quality bias but also a modest high yield credit position for the yield pickup. A sudden move up in yields could present a good entry point to lengthen duration and move toward a neutral position.

Within high quality bonds, we prefer mortgage-backed securities (MBS) relative to government bonds. MBS underperformed in 2019 as interest rates sharply declined (MBS are less sensitive to interest rate changes). Moreover, the Fed also reduced the amount of MBS on its balance sheet, which contributed to rising MBS spreads. We also maintain a neutral position in investment grade corporate bonds, but will look to add on any significant spread widening.

We favor a slightly short duration stance relative to our core taxable fixed income benchmark to start the year. Longer duration bond sectors, such as fixed-rate preferred securities, have become less attractive. However, given the low-yield environment and easy global monetary policies, the downside is likely limited over the near term.

Investment Grade Corporate Bonds

We expect coupon-like returns in 2020. Fundamentals are slightly more challenged with increasing leverage, interest coverage ratios slipping and spreads that are toward the lower end of their multi-year range. However, we still expect solid demand given the yield pickup and low near-term recession risks. With credit spreads near the lows of their three-year range (Figure 16), we prefer an up-in-quality bias. We expect spreads to move slightly wider during the year and would consider adding to exposure tactically as this widening occurs.

High Yield Corporate Bonds

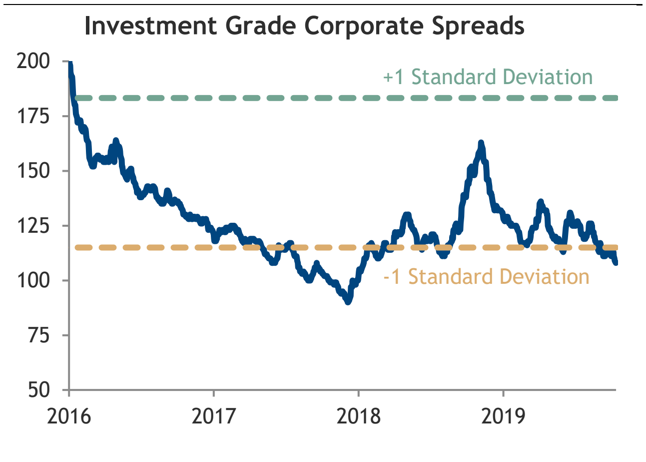
Like their investment grade counterparts, we expect coupon-like returns for high yield corporate bonds. With credit spreads near the low-end of their multi-year range and defaults creeping upwards, the bias is for modest spread widening. However, we still maintain a position due to the attractive yield pickup in this low-rate environment (Figure 17). We favor active management in the high yield space given the bifurcation of returns and idiosyncratic risks.

Municipal Bonds

The push and pull continues for municipal bonds as valuations are expensive, while demand seems insatiable. In fact, there have been 48 straight weeks of inflows into municipal bond funds in 2019. As the credit cycle ages, we prefer credits with essential revenues like water and sewer bonds, and dedicated revenue streams like toll roads and hub airports, while maintaining an underweight to local general obligation and smaller private college debt. The longer end of the curve—10 years plus—represents better valuations compared to US Treasuries, and the municipal curve is steeper as well. Thus, we favor a neutral duration with a barbell strategy.

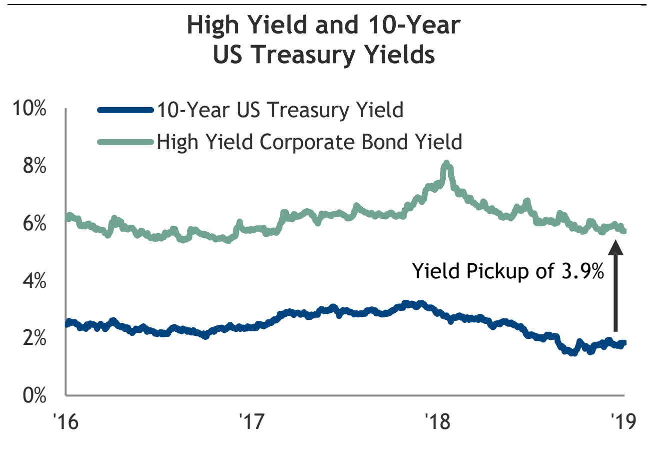
The 2018 tax reforms continue to affect the dynamics of the market. In response, municipalities

Figure 16: Investment Grade Corporates Expensive



Data Source: SunTrust IAG, FactSet
A credit spread is the difference in yield between two bonds of similar maturity but different credit quality.

Figure 17:
High Yield Bonds Expensive but Still Offer Attractive Yield



Data Source: SunTrust IAG, FactSet
High Yield's yield is represented by the yield to worst which is adjusted for embedded options.

looking to refinance debt at lower levels have begun to use taxable debt. We expect this taxable municipal issuance to increase in 2020, and this should slightly diminish the issuance of new tax-free debt. This represents an opportunity for buyers of investment grade corporate debt to diversify into another sector without sacrificing yield.

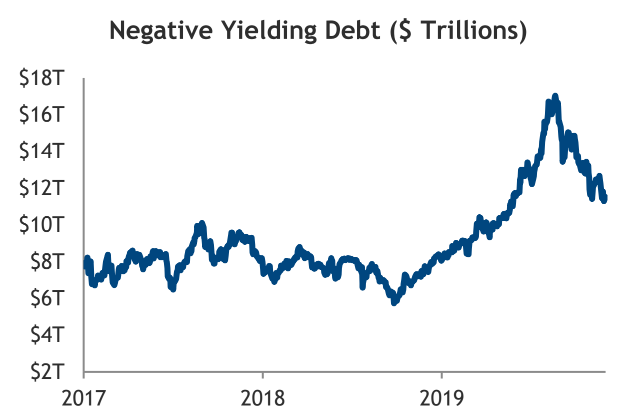
International Developed Markets Sovereign Bonds

International developed markets (IDM) sovereign bonds were one of the few laggards in 2019, significantly underperforming the US core taxable benchmark, driven by lower yields and currency losses. We still view hedged and unhedged bonds in this space as unattractive on a relative basis given that a significant portion of this asset class has negative yields (Figure 18), is highly sensitive to changes in interest rates and subject to heightened political risks. Interest rates have moved off the lows, but shorter-term rates will likely be anchored by low policy rates set by the ECB and Bank of Japan. Longer-term rates should move in tandem with the latest economic news. However, given our expectation for only a modest economic rebound, the upside in rates should be limited, especially with rising central bank balance sheets as the ECB restarts asset purchases.

Emerging Markets (EM) Bonds

Yields for hard currency EM bonds, including sovereigns and corporates, have declined to their lowest levels since 2017, while local currency EM bond yields are near their lowest levels since 2013. Hard currency sovereign and corporate bonds, with yields over 5%, appear attractive on a relative basis and should be supported by our global outlook and the demand for yield. Investors should understand, however, that the higher yield is reflective of the inherent risks in the space. Approximately 40% of the benchmark is in below investment grade bonds. EM local bonds carry even more risk, and we recommend investors continue to avoid them.

Figure 18:
Negative Yielding Debt Is Concentrated in Europe & Japan



Data Source: SunTrust IAG, Bloomberg
Negative Yielding Debt represented by the market value of the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index

NON-TRADITIONAL STRATEGIES

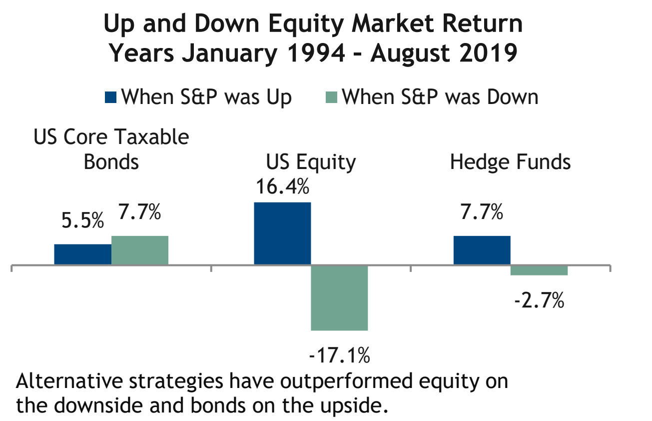
Given our outlook for moderating equity and fixed income returns, non-traditional strategies provide opportunities for portfolio diversification and ballast.

We favor an anchor position in diversified hedge funds, which provide some level of performance consistency as well as a differentiated return stream and ballast during bouts of market turmoil (Figure 19). The active management backdrop looks to be improving for hedge funds as the cycle matures and asset class returns diverge.

We see a more favorable environment for hedged equity strategies, where managers can take advantage of dispersion across market segments. We are also becoming more constructive on event driven hedge funds, which are less correlated to the economic cycle and provide exposure to companies undergoing corporate events, typically later in the cycle. While global merger activity has moderated, we still see opportunity in the space. Relatively low yields and few defaults, however, elevate the risk profile of select credit strategies. As the cycle further matures and leverage moves higher, we could eventually see better opportunities in the distressed credit space.

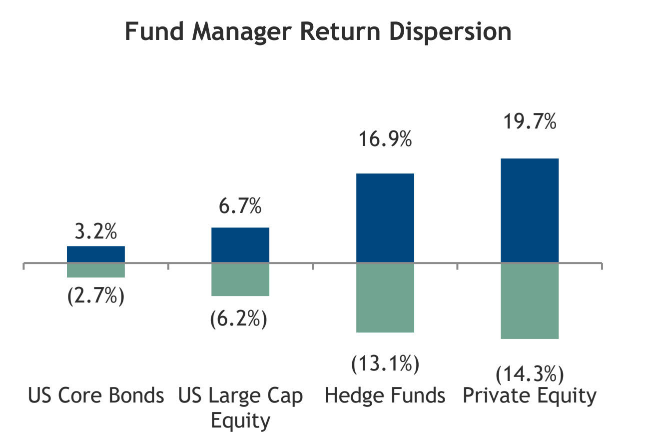
While we continue to see opportunities in select hedge fund strategies, manager performance varies significantly, and the importance of manager selection remains critical (Figure 20).

Figure 19:
Alternatives Provide Potential Diversification Benefits



Data Source: SunTrust IAG, FactSet; Core taxable bonds represented by the Bloomberg Barclays US Aggregate Bond Index, US equity represented by the Standard & Poor’s 500 Index and Hedge Funds represented by the HFRI FOF: Diversified Hedge Fund Index.

Figure 20:
Hedge Fund Manager Selection Is Key



Data Source: SunTrust IAG, FactSet, Haver, Hedge Fund Research, Morningstar, Barclay Hedge, BlackRock

Hedge fund investing involves substantial risks and may not be suitable for all clients. Hedge funds are intended for sophisticated investors who can bear the economic risks involved. Hedge funds may engage in leveraging and speculative investment practices that may increase the risk of investment loss, can be illiquid, and are not required to provide periodic pricing or valuation information to investors. Hedge funds may involve complex tax structures, have delays in distributing tax information, are not subject to the same regulatory requirements as mutual funds and often charge higher fees.

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High Yield Fixed Income Investments, also known as junk bonds, are considered speculative, involve greater risk of default and tend to be more volatile than investment grade fixed income securities.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include potential economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in emerging market countries, since these countries may have relatively unstable governments and less established markets and economies.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations, and illiquidity.

Emerging Markets: Investing in the securities of such companies and countries involves certain considerations not usually associated with investing in developed countries, including unstable political and economic conditions, adverse geopolitical developments, price volatility, lack of liquidity, and fluctuations in currency exchange rates.

Asset classes are represented by the following indexes:

MSCI ACWI index (Morgan Stanley Capital International All Country World) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

The Nikkei is an abbreviation for Japan's foremost, best known, and most respected stock index of Japanese companies. Its full name is Nikkei 225 Stock Average. This index is price weighted and made up of the top 225 industry leading companies which investors trade on the Tokyo Stock Exchange.

Investment grade corporate bonds are represented by the Bloomberg Barclays US Corporate Investment Grade Bond Index which includes publicly-issued US corporate and specified foreign debentures and secured notes which have at least one year to maturity, have at least $250 million par amount outstanding, are fixed rate, and are rated investment grade.

Aaa Corporate Bonds are represented by the Bloomberg Barclays US Aaa Corporate Bond Index which is the Aaa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Aa Corporate Bonds are represented by the Bloomberg Barclays US Aa Corporate Bond Index which is the Aa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

A Corporate Bonds are represented by the Bloomberg Barclays US A Corporate Bond Index which is the A component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Baa Corporate Bonds are represented by the Bloomberg Barclays US Baa Corporate Bond Index which is the Baa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

HFRI FOF: Diversified Hedge Fund Index. HFRI Fund of Funds Composite: This is an equal-weighted index of 650 hedge funds with at least $50 million in assets and 12-months of returns. Returns are reported in US dollars and are net of fees. HFRI Fund of Funds: Fund of funds invest with multiple hedge fund managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. HFRI may revise index data from time to time, as necessary.

MSCI EAFE index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

MSCI EM index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Russell 2000 Index is comprised of 2000 smaller company stocks and is generally used as a measure of small-cap stock performance.

Bloomberg Barclays Municipal Bond Blend 1-15 Year (1-17 Yr) is an unmanaged index of municipal bonds with a minimum credit rating of at least Baa, issued as part of a deal of at least $50 million, that have a maturity value of at least $5 million and a maturity range of 12 to 17 years.

Core Bonds are represented by the Bloomberg Barclays US Aggregate Bond Index which is the broadest measure of the taxable US bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, and maturities of one year or more.

JP Morgan GBI-EM Global Diversified Composite is a comprehensive emerging market debt index that tracks local currency bonds issued by Emerging Market governments. It includes only those countries that are directly accessible by most of the international investor base and excludes countries with explicit capital controls, but does not factor in regulatory/tax hurdles in assessing eligibility. The maximum weight to any country in the index is capped at 10%.

BofAML US HY Master index is an index that tracks US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

BofA Merrill Lynch Global Fixed Income Markets Index tracks the performance of developed and emerging market investment grade and sub-investment grade debt publicly issued in the major domestic and eurobond markets.

Leveraged Loans are represented by the Credit Suisse Leveraged Loan index which is a representative index of tradable, senior secured, US dollar denominated non-investment-grade loans.

Bank-loan portfolios primarily invest in floating-rate bank loans and floating-rate investment-grade securities instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR.

The FTSE Japan index is a market-capitalization weighted index representing the performance of Japanese large and mid cap stocks.

The DAX is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

The FTSE 100 is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization.

It is not possible to invest directly in an index.

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